SAN PEDRO SULA MUNICIPAL DEVELOPMENT PROGRAM (HO-0115)
TEGUCIGALPA MUNICIPAL DEVELOPMENT PROGRAM (HO-0135)

EXECUTIVE SUMMARY

Borrower	Republic of Honduras
Executing Agency	Ministry of Finance through Private Trust

Amount and Source		First Phase *(covered by the attached resolution)*	Second Phases *(to be presented to the Board at a later stage)*
San Pedro Sula Account	IDB Financing (FSO)	US$27 million	US$09 million
	Local Counterpart	US$03 million	US$01 million
	Total	US$30 million	US$10 million
Tegucigalpa Account	IDB Financing (FSO)	US$36 million	US$15 million
	Local Counterpart	US$04 million	US$10 million
	Total	US$40 million	US$25 million
Total	IDB Financing (FSO)	US$63 million	
	Local Counterpart	US$07 million	
	Total	US$70 million	

Terms and conditions	Amortization period	40 years with 10 year grace
	Disbursement period	5 years
	Interest rate	1% for the first ten years 2% thereafter
	Inspection and supervision	1.0%
	Credit fee	0.5%

Objectives

The proposed Program aims at a sustainable improvement in urban services in Tegucigalpa and San Pedro Sula. The strategy for achieving this improvement has two principal elements: an overhaul of the municipalities' financial management, and the modernization of the arrangements for service provision. The financial overhaul will rely on instituting greater transparency (better information made widely available in formats consistent with accepted standards), greater efficiency (in the management of both expenditure control and revenue collection), and more rigorous discipline (access to credit will be automatically controlled through the independent and timely monitoring of financial benchmarks). Alongside this financial reform, the municipalities will implement a strategy for improving the arrangements for delivering urban services, most notably potable water and sewage, roads and public transport, solid waste management, and management of marginal neighborhoods. This will involve wider use of private sector firms in actual service delivery, together with a radical reorganization and strengthening of the municipalities' capacity to supervise the performance of private providers.

Description

The Program will support these objectives by financing: (1) technical assistance to improve the municipalities' financial management and service supervisory capacity; (2) the implementation of action plans for restructuring the above services, using service, leasing or concession contracts to transfer operational and, where possible, investment responsibilities to private firms; and (3) eligible municipal investments for responsibilities not transferred to private parties under the restructuring plans. Access to investment funding will be linked to compliance with performance benchmarks and transaction-oriented conditionalities, as spelled out in the eligibility matrices presented in Annex III-1.

Under the San Pedro Sula component, the Program will: (1) foster an overall reorganization of the Municipality; (2) help modernize municipal finance by developing an income enhancement strategy, establishing reliable financial information systems, and fostering transparent management practices (US$1 million); (3) transform the Municipality's environmental management unit into a regulatory unit (US$250,000); (4) help corporatize the municipal water agency and finance short-term investments in support of the privatization (US$9 million); (5) support the decentralization of public transport to the municipal level, help establish a semi-autonomous urban transport agency with dedicated sources of funding, and finance key public transport and road investments (US$7 million); (6) help contract out solid waste management services and finance the rehabilitation and expansion of the existing landfill (US$2 million); and (7) help the Municipality implement a comprehensive strategy to up-grade existing marginal neighborhoods and rationalize future urban growth (US$9.5 million).

Under the Tegucigalpa component, the Program will: (1) help modernize municipal finance by developing an income enhancement strategy, establishing reliable financial information systems, and fostering transparent management practices (US$1 million); (2) transform the Municipality's environmental management unit into a regulatory unit (US$250,000); (3) support the decentralization of public transport to the municipal level, help strengthen the key functions of the urban transport sector (planning, programming and contracting), establish a financing mechanism to ensure road maintenance, and finance key public transport and road investments (US$17 million); (4) help contract out solid waste management services, help create microenterprises for service provision in marginal neighborhoods, and finance the rehabilitation of the existing landfill and development of a new landfill site (US$1 million); and (5) help the Municipality implement a comprehensive strategy to legalize land ownership, upgrade existing marginal neighborhoods, and rationalize future urban growth (US$18 million).

Program Phasing. Bank support to each of the two cities will be divided into two phases in order to account for a series of limitations that the municipalities presently have in their capacity to implement the proposed Program. The first phases will be financed through the loan outlined in the attached resolution. Each of the second phases would be financed through separate loans (one for each city), to be presented to the Board through a memorandum referencing the present document and presenting evidence that pre-agreed trigger conditions have been met.

The presentation of the San Pedro Sula Second Phase (US$9 million) to the Board would be triggered by the Municipality's implementation of a Bank-approved plan to restructure the outstanding debt on a municipal bond issued two years ago to finance a sports stadium. This is expected to happen within the next eighteen months. (See paragraph 1.23).

The presentation of the Tegucigalpa Second Phase (US$15 million) to the Board would be triggered by the signature of a Bank-approved agreement (between by the Municipality and the Central Government) to transfer the responsibility for potable water and sewage services from the Central Government to the Municipality. This is expected to happen within the next twelve months. (See paragraph 2.25).

Execution arrangements. Resources will be passed on to the two municipalities through a trust fund (hereafter referred to as the Municipal Development Trust Fund, MDTF), which will have two distinct accounts, one for each city. The MDTF will be managed by a private, competitively selected local commercial bank.

The MDTF will grant subloans based on the eligibility matrix agreed upon for each city. Subloans will carry a variable rate (eighty-five percent of the average passive rate in the local banking system) and a maturity reflecting the economic life of project asset (with a one-year grace). Each subloan will come with a cascade of guarantees aimed at ensuring that the sovereign guarantee does not need to be called. Re flows from subloans will be used by the Government to repay the IDB debt. Any excess would be used to finance municipal projects under conditions similar to that of the Program.

Relationship of Project in Bank's country and sector strategy	The proposed Program is part of a new generation of Bank operations aimed at wholesaling Bank resources to municipalities. It should be seen as a first step which beneficiary municipalities are taking on the way to strengthening their financial management in order to access financial markets. This step is consistent with the strong decentralization movement that has been taking place in Honduras since the beginning of the decade.
Environmental and Social Review	Due to the nature of the Program, no project-specific Environmental Impact Assessment (EIA) was carried out ex-ante. However, institutional mechanisms will be established as part of the Program to ensure streamlined but effective review of environmental and social impacts (see paragraphs 2.29 and 2.59).
Benefits	The reforms sponsored by the Program will yield two major benefits. First, they will bring about discipline and transparency in the financial management of the municipalities, which should result in enhanced resource allocation. Second, they will improve the efficiency and equity of service delivery, through increased pricing and management efficiencies. This will enable expanded service coverage for the poor.
Risks	Implementation capacity. Both operations are complex: they entail full-fledged reforms of most service sectors under municipal responsibility. In this respect, they are the municipal equivalent of a structural adjustment operation. The capacity of the municipal administrations to implement the proposed reforms will be key in ensuring the sustainability of the proposed Program. In both municipalities, there are encouraging signs: a clear political will on the part of the municipal executive, a high level of technical competence on the part of higher management, and a strong consensus that reforms are necessary. It is the Project Team's opinion that both municipalities are well prepared to initiate the reform process. Political risks. Working with municipalities entails a different set of risks involving intergovernmental relations. Short-term risks are present mainly in Tegucigalpa, where the municipal and central governments are from different parties. The proposed financing mechanism has been designed to shield the Program from short-term political risks: appraisal of specific projects will be delegated to a technically competent, politically neutral third party (the Trustee), while the Bank's Country Office in Honduras will make final project approval decisions, initially at least. Long-term risks are inherent to long-term sub-sovereign lending, especially where the municipal finance market is too incipient to impose discipline. For the next fifteen years, the way the municipalities are managed will be one of the most important factors influencing their capacity to repay the

various loans they will secure from the MDTF. While the Bank is ultimately covered by the Sovereign's guarantee, a series of features have been included in the proposed Program to reduce the uncertainty of future municipal management. First, whenever possible, the proposed service reforms will be institutionalized through long-term contractual arrangements (service contracts, concessions), making reforms more irreversible. Second, for each specific subloan granted by the MDTF, a series of self-standing guarantees will be established to mitigate risks of municipal default.

Special contractual conditions

As a condition prior to first disbursement, the Borrower will submit evidence to the Bank that:

(1) The MDTF has been legally established and the Credit Guidelines governing its operations have entered into effect in a form substantially equal to that of the draft guidelines agreed with the Bank; in particular, the Credit Guidelines will incorporate the eligibility matrices presented in Annex III-1 (see paragraph 3.1);

(2) An agreement between the Central Bank and the Ministry of Finance has entered into effect specifying the procedures which the Central Bank will follow to debit and credit the MDTF accounts (see paragraph 3.1); and

(3) The MDTF Trustee has been recruited according to the terms of reference agreed upon with the Bank (see paragraph 3.1).

Other contractual conditions. The loan contract will provide for the reimbursement of expenditures incurred by the municipalities to finance activities eligible under the Program in accordance with Bank procedures, for an amount up to US$500,000 per municipality (see paragraph 3.19).

Emergency measures. The loan contract will also allow the following temporary exceptions to the Program's execution arrangements in order to address the emergency conditions recently brought on by the Tropical Storm Mitch (see paragraphs 3.21 and 3.22).

(1) Until the end of the sixth month after the loan contract has entered into effect or until the MDTF becomes operational, whichever comes first, the two municipalities will be authorized to commit and spend Program resources up to an amount of US$12 million for Tegucigalpa and US$9 million for San Pedro Sula without meeting the special contractual conditions (1) to (3) above. Instead, the following conditions will apply:

- Resources may only be used to finance studies and works for elements of infrastructure (a) in sectors covered by the Program and (b) which have been destroyed or damaged by the storm.
- Specific activities must be authorized ex-ante by the Bank's Country Office in Honduras.
- The municipality must commit to repay the activity to be financed under the terms outlined in paragraph 3.12.

(2) During the first six months the loan contract is in effect, streamlined procurement procedures will apply (see below).

(3) All subloans approved during the first year of effectiveness of the loan contract will have a maturity of forty years. At the end of the first year, the Government of Honduras and the Bank will review the financial situation of the municipalities and decide whether to extend the forty-year maturity to non-committed resources or to come back to the original proposal of a twenty-five-year maximum maturity, taking into account the original objectives of the Program.

Poverty Targeting and Social Sector Classification

The economic evaluation carried out suggests that the proposed Program is a Poverty Targeted Investment (PTI) since about 55% of the Tegucigalpa and 45% of the San Pedro Sula beneficiaries are below the Bank's poverty threshold. In absolute value, Program benefits are likely to accrue in vast majority to the poor. In Tegucigalpa, the water component and the marginal neighborhood component are the two most poverty-targeted components. They will mobilize 66% of Tegucigalpa resources and 80% of their benefits will accrue to households under the poverty threshold. In San Pedro Sula, the marginal neighborhood component is the most poverty-targeted component. Its amount represents 50% of San Pedro Sula resources and its benefits will accrue almost entirely to the poor. The water component (30% of San Pedro Sula resources) will also benefit the poor in a significant fashion: it will result in a strong redistribution of welfare from richer neighborhoods presently consuming too much under-priced water to marginal areas currently not receiving service. (See paragraphs 4.9 to 4.11.)

Consequently, it is proposed to apply paragraph 2.93 of the FSO Eighth Replenishment document (AB-1704) and have IDB financing account for up to 90% of total Program amount.

Exception to Bank policies

None

Procurement All contracting will follow the Bank's policies. International public bidding will be used for procurement of works in excess of US$1,000,000 and for acquisition of goods and services in excess of US$350,000. National procurement regulations will apply under these thresholds (see paragraph 3.14).

However, during the first six months the loan contract is in effect, streamlined procurement procedures will apply, as per the Bank's draft policy on procurement procedures for emergency projects recently submitted to the Board (see paragraph 3.21).